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The Great Debate

## Will someone please put Fannie and Freddie out of their misery?

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Toll Brothers luxury homes are shown sold before construction is completed in Oceanside, California, August 20, 2013. REUTERS/Mike Blake

Federal Reserve Chair Janet Yellen's speech on Wednesday made the case that the Fed's policy response to the financial crisis has put the system on much sounder ground. Perhaps, but policymakers' work is not over.

Something has to be done with Fannie Mae and Freddie Mac. These too-big-to-fail financial giants buy mortgage loans, package them into mortgage securities and guarantee investors in these securities against any losses if borrowers default on their loans.

The problem is that Fannie Mae and Freddie Mac are owned by U.S. taxpayers, who are thus effectively making most of the nation's mortgage loans. They have been since the government had to take over the two mortgage-finance giants during the 2008 financial collapse.



Fannie Mae headquarters in Washington, February 21, 2014. REUTERS/Kevin Lamarque

Yet policymakers display surprisingly little urgency to fix the problem. The last Congress even failed to get a full vote on substantive reform legislation. The current Congress shows little intention of seriously taking up the issue, and the Obama administration has been largely mum.

The status quo has held because the housing finance system is functioning. Mortgage loans are being made. This is vital to the housing market and broader economy.

But the current system is untenable. It makes little sense that taxpayers should be shouldering most of the burden of financing almost \$5 trillion in outstanding mortgage loans. Private financial institutions and investors are more than willing to take on much of this risk.

The system will likely become increasingly unable to provide mortgage loans to creditworthy borrowers. Borrowers are changing as the Latino and Asian populations rapidly expand and millennials come of age. Fannie Mae and Freddie Mac in government hands won't be innovative enough to provide the mortgage loans these groups will need.

Because Freddie Mac is big but far smaller than Fannie Mae, it is unable to charge as high a fee for its services. This gap is set to get larger with the end of the Federal Reserve's quantitative easing program, under which the Fed was buying lots of the two firms' mortgage securities. At the very least, this means taxpayers aren't getting all the profits they should from Freddie Mac. Worse, it may mean that Freddie Mac won't be viable in the long run.





A pedestrian walks past a sign advertising new condominium homes for sale in South San Francisco, California, December 22, 2009. REUTERS/Robert Galbraith

Changing the system is critical but must be done judiciously. Nothing should disrupt mortgage lending today because the housing recovery is still fragile. Taxpayers should also end up with far less risk and private institutions and investors with far more.

Taxpayers need to continue to backstop the financial system against calamities like the financial collapse. With this backstop, mortgage rates will be far lower, which allows for more home ownership. The popular 30-year fixed-rate mortgage can remain widely available as well. But taxpayers should be compensated by mortgage borrowers for providing this service.

Any change to the system should also introduce more competition among the private institutions and investors that take on the risk of mortgage lending. More competition will lead to more innovation, and thus more choices for mortgage borrowers at lower interest rates.

Lower-income borrowers should continue to get a break in the future housing finance system. Taxpayers now subsidize mortgage loans to these people through Fannie and Freddie, but the subsidy is opaque and not nearly as effective in reaching these groups as it could be. Instead, the subsidy could be made through explicit and transparent reductions in mortgage rates for these borrowers.

Accomplishing all this is a heavy lift politically. Legislation anytime soon is unlikely. Further complicating matters are various lawsuits by legacy Fannie Mae and Freddie Mac shareholders, who believe the government inappropriately took their property when it took over the institutions. Their arguments seem specious, but until the courts settle the dispute, policymakers feel hamstrung.



Police tape marked as a Foreclosure Free Zone is seen outside the foreclosed home of Marie Elie in Elmont, New York, April 9, 2009. REUTERS/Shannon Stapleton

Yet serious housing-finance reform can be done without new legislation. To some extent, Fannie Mae and Freddie Mac's regulator, the Federal Housing Finance Agency, is already doing it.

The agency requires Fannie Mae and Freddie Mac to share the risk when backing a mortgage loan with private institutions and investors. To their credit, the two firms are increasingly innovative in how and with whom they share risk. They need, however, to work on a set timeline to off-load most of their risk. Eventually, they should provide private players only a backstop against calamity.

Fannie Mae and Freddie Mac can reduce fees as they off-load risk. However, their fees should be designed to ensure that low-income households have the same access to mortgage loans in the future as they have now.

The Federal Housing Finance Agency also wants Fannie Mae and Freddie Mac to combine their platforms for turning mortgage loans into securities. Each firm now has its own way of doing this, which adds to the costs and also makes it difficult for others to compete. They should be required to construct a common securitization platform that they and other financial institutions can use.

A common platform would allow Fannie Mae and Freddie Mac eventually to issue the same mortgage security. In doing this, they would effectively become one institution; costs would be reduced and Freddie Mac would not become a liability.

There has been a lot of hand-wringing over Fannie Mae and Freddie Mac. Fixing these institutions is the last significant unfinished business from the 2008 financial collapse and Great Recession.

Washington gridlock will likely ensure that this won't happen legislatively. But through resolve and guidance, the Federal Housing Finance Agency could accomplish this. The nation's housing finance system would end up in a place that works well for taxpayers, homebuyers and the economy.

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